No. 84-679

In the Supreme Court of the United States

OCTOBER TERM, 1984

Supreme Court, U.S.
FILED
MAR 27 1985
ALEXANDER L. STEVAS,
CLERK

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
PETITIONER

v.

CARL F. BERNER, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING RESPONDENTS

REX E. LEE
Solicitor General

LOUIS F. CLAIBORNE
Deputy Solicitor General

BRUCE N. KUHLIK
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

LARRY R. LAVOIE
Assistant General Counsel

COLLEEN P. MAHONEY
Special Counsel

DANIEL J. KRAUS
Attorney
Securities and Exchange Commission
Washington, D.C. 20549

QUESTION PRESENTED

Whether an employee of a brokerage firm who induces investors to purchase securities by deliberately misrepresenting that he is communicating material nonpublic information about the issuer should be permitted to avoid liability to those investors in a private damages action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder on the ground that the defrauded investors are *in pari delicto* with him because they purchased securities on the false premise that they were tippees.

TABLE OF CONTENTS

	Page
Interest of the Securities and Exchange Commission	1
Statement	2
Summary of argument	5
Argument:	
An employee of a brokerage firm who induces investors to purchase securities by deliberately misrepresenting that he has obtained material nonpublic information about the issuer should not be permitted to shield himself from damages liability under Rule 10b-5 on the ground that the defrauded investors are *in pari delicto* with him because they purchased securities on the false premise that they were tippees	6
A. The common law *in pari delicto* defense should be applied only where the plaintiff's fault is, under all the circumstances, relatively equal to the defendant's and application of the defense advances the objectives of the securities laws	8
B. Because the securities professional in this case was far more culpable than the victims of his manipulative scheme, he cannot avoid liability under the *in pari delicto* doctrine	16
C. Allowing duped investors to recover their trading losses from the securities professional who defrauded them promotes the purposes of the federal securities laws	21
1. Denial of the *in pari delicto* defense in this case promotes Congress's purpose to impose high ethical standards on securities professionals and to deter them from engaging in fraudulent and manipulative schemes	23
2. Denial of the *in pari delicto* defense in this case will best achieve Congress's objective to deter illegal tippee trading	27
Conclusion	30

TABLE OF AUTHORITIES

Cases: Page

A.C. Frost & Co. v. *Coeur D'Alene Mines Corp.*, 312 U.S. 38 8
American Power & Light Co. v. *SEC*, 329 U.S. 90 22
American Society of Mechanical Engineers, Inc. v. *Hydrolevel Corp.*, 456 U.S. 556 13
Barnes v. *Brown*, 32 Mich. 146 11
Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723 ..... 1, 8, 15
Brady v. *Central W.R.R.*, 88 Net. 840, 130 N.W. 575 11
Chemetron Corp. v. *Business Funds, Inc.*, 682 F.2d 1149, vacated, 460 U.S. 1007 16
Chiarella v. *United States*, 445 U.S. 222 21
Dirks v. *SEC*, No. 82-276 (July 1, 1983) 5, 16, 17, 21
E.J. Arnold & Co., In re, 133 F. 789 10
Ernst & Ernst v. *Hochfelder*, 425 U.S. 185 ..... 4, 23, 28
FCC v. *National Citizens Committee for Broadcasting*, 436 U.S. 775 22
FPC v. *Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1 22
Falkenberg v. *Allen*, 18 Okla. 210, 90 P. 415 ..... 9-10, 11
Fratt v. *Robinson*, 203 F.2d 627 24
Gilchrist v. *Hatch*, 183 Ind. 371, 106 N.E. 694 ..... 10, 11
Golberg v. *Sanglier*, 96 Wash. 2d 874, 639 P.2d 1347 ..... 10, 12
Gorringe v. *Reed*, 23 Utah 120, 63 P. 902 10
Grim v. *Cheatwood*, 208 Okla. 570, 257 P.2d 1049 11
Grumet v. *Shearson/American Express, Inc.*, 564 F. Supp. 336 22
Harrety v. *Kontos*, 238 Mo. App. 519, 184 S.W.2d 195 11
Hatrock v. *Edward D. Jones & Co.*, No. 83-4182 (9th Cir. Dec. 28, 1984) 8, 24
Haven Industries, Inc., In re, 462 F. Supp. 172 ..... 22, 24
Herman & MacLean v. *Huddleston*, 459 U.S. 375 ..... 8, 12, 15, 23, 29
Hess v. *Culver*, 77 Mich. 598, 43 N.W. 994 11
Hobbs v. *Boatright*, 195 Mo. 693, 93 S.W. 934 10
J.I. Case Co. v. *Borak*, 377 U.S. 426 ..... 1, 15

Cases—Continued: Page

James v. *DuBreuil*, 500 F.2d 155 ..... 7, 22
Kirkland v. *E.F. Hutton & Co.*, 564 F. Supp. 427 ..... 22, 24
Kuehner v. *Texstar Corp.*, 412 F.2d 700 ..... 14, 22, 25, 27, 28
Lockman v. *Cobb*, 77 Ark. 279, 91 S.W. 546 11
Malamphy v. *Real-Tex Enterprises, Inc.*, 527 F.2d 978 21
Mallis v. *Bankers Trust Co.*, 615 F.2d 68, cert. denied, 449 U.S. 1123 ..... 7, 16
Mansbach v. *Prescott, Ball & Turben*, 598 F.2d 1017 19
McMullen v. *Hoffman*, 174 U.S. 639 8
Moholt v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. 451 ..... 14, 22, 24, 30
Nathanson v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 ..... 14, 22, 24, 27, 28
National Bank & Loan Co. v. *Petrie*, 189 U.S. 423 10
National City Bank v. *Carter*, 31 F.2d 25, cert. denied, 280 U.S. 559 ..... 10, 12
Perma Life Mufflers, Inc. v. *International Parts Corp.*, 392 U.S. 134 ..... *passim*
Rolf v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, cert. denied, 439 U.S. 1039 19
Rozell v. *Vansyckle*, 11 Wash. 79, 39 P. 270 11
SEC v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 ..... 12, 15, 23
SEC v. *Chenery Corp.*, 332 U.S. 194 22
SEC v. *New England Electric System*, 390 U.S. 207 22
Schick v. *Steiger*, 583 F. Supp. 841 ..... 17-18, 19
Silverberg v. *Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678 ..... 7, 19
Sparkman v. *Triplett*, 292 Ky. 569, 167 S.W.2d 323 11
Staufenbiel v. *Staufenbiel*, 388 Ill. 511, 58 N.E.2d 569 11
Stewart v. *Wright*, 147 F. 321, cert. denied, 203 U.S. 590 ..... 10, 11
Summerlin v. *Blyth Eastman Dillon & Co.*, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197 (N.D. Ga. Mar. 23, 1983) 19, 22
Tarasi v. *Pittsburgh National Bank*, 555 F.2d 1152, cert. denied, 434 U.S. 965 ..... 14, 18, 21, 27

Cases—Continued: Page

Texas Industries, Inc. v. *Radcliff Materials, Inc.*, 451 U.S. 630 26
Thompson v. *Lyons*, 281 Mo. 430, 220 S.W. 942 11
Tri Q, Inc. v. *Sta-Hi Corp.*, 63 Cal. 2d 199, 404 P.2d 486, 45 Cal. Rptr. 878 12
United States v. *Naftalin*, 441 U.S. 768 23
United States v. *Shimer*, 367 U.S. 374 22
Wager v. *Pro*, 575 F.2d 882 18
Webb v. *Fulchire*, 25 N.C. 485 11
Wilkinson v. *Paine, Webber, Jackson & Curtis, Inc.*, 585 F. Supp. 23 19
Wise v. *Kidder Peabody & Co.*, 596 F. Supp. 1391 19
Wolfson v. *Baker*, 623 F.2d 1074, cert. denied, 450 U.S. 966 21
Woolf v. *S.D. Cohn & Co.*, 515 F.2d 591, on reh'g, 521 F.2d 255, vacated, 426 U.S. 944 16
Wright v. *Stewart*, 130 F. 905, aff'd, 147 F. 321, cert. denied, 203 U.S. 590 12
Xaphes v. *Shearson, Hayden, Stone, Inc.*, 508 F. Supp. 882 19

Statutes, regulation and rules:

Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 *et seq.* 21, 29
§ 2, 98 Stat. 1264 21
§ 3, 98 Stat. 1265 29
Securities Act of 1933, § 11(f), 15 U.S.C. 77k(f) 26
Securities Exchange Act of 1934, 15 U.S.C. 78 *et seq.*:
§ 9, 15 U.S.C. 78i 26
§ 9(a)(3)-(5), 15 U.S.C. 78i(a)(3)-(5) 24
§ 9(e), 15 U.S.C. 78i(e) 24, 26
§ 10(b), 15 U.S.C. 78j(b) ..... *passim*
§ 18(b), 15 U.S.C. 78r(b) 26
§ 20(a), 15 U.S.C. 78t(a) 2, 7
17 C.F.R. 240.10b-5 ..... *passim*
Fed. R. Civ. P. 12(b)(6) 2
Sup. Ct. R. 19.6 2
Comment, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses*, 58 Cal. L. Rev. 1149 (1970) 28

Miscellaneous: Page

Comment, *Securities Regulation—In Pari Delicto as a Bar to Private Antifraud Action by Tippee against Tipper*, 43 Mo. L. Rev. 378 (1978) 25, 28
H.R. Rep. 98-355, 98th Cong., 1st Sess. (1983) 21
5B A. Jacobs, *Litigation and Practice Under Rule 10b-5* (2d rev. ed. 1984) 20
S. Jaffe, *Broker-Dealers and Securities Markets* (1977) 19-20
Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 Vand. L. Rev. 1273 (1984) 20, 29
3 L. Loss, *Securities Regulation* (2d ed. 1961) 26
L. Loss, *Fundamentals of Securities Regulation* (1983) 6
Model Penal Code § 5.01(1)(a) (Proposed Official Draft 1962) 18
Phillips, *When a Broker Takes a Client for a Ride*, Bus. Wk., Feb. 25, 1985 25
3 J. Pomeroy, *A Treatise on Equity Jurisprudence* (5th ed. 1941) 10, 11
Restatement (Second) of Torts (1977) 12
Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597 (1972) 26
S. Rep. 1455, 73d Cong., 2d Sess. (1934) 23
Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess. (1934) 23
J. Story, *Commentaries on Equity Jurisprudence* (1886) 12
Wade, *Restitution of Benefits Acquired Through Illegal Transactions*, 95 U. Pa. L. Rev. 261 (1947) 9, 10, 11
Wechsler, Jones & Korn, *The Treatment of Inchoate Crimes in the Model Penal Code of the American Law Institute: Attempt, Solicitation, and Conspiracy*, 61 Colum. L. Rev. 571 (1961) 18
N. Wolfson, R. Phillips & T. Russo, *Regulation of Brokers, Dealers and Securities Markets* (1977 & Supp. 1984) 20

In the Supreme Court of the United States

OCTOBER TERM, 1984

No. 84-679

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
PETITIONER

v.

CARL F. BERNER, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING RESPONDENTS

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission is principally responsible for ensuring that securities brokerage firms and their employees comply with the federal securities laws. Private damages actions brought by investors under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b-5 thereunder (17 C.F.R. 240.10b-5) serve as a "necessary supplement" to the efforts of the Commission to protect investors from fraudulent practices by securities professionals. See *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 730 (1975); *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964) ("As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the [securities laws].").

The Commission is concerned that the unduly broad application of the common law *in pari delicto* defense urged by petitioner will encourage securities professionals to engage in dishonest practices. In the Commission's view, it is important to vindicate the holding of the court of appeals that securities professionals may not use the *in pari delicto* defense to immunize themselves from private damages actions by the victims of their manipulative or fraudulent schemes merely because, as part of those schemes, they fraudulently induce investors to believe that they are trading on inside information.

STATEMENT

1. Petitioner Bateman Eichler, Hill Richards, Inc. is a securities brokerage firm. Respondents are investors who filed this action in the United States District Court for the Northern District of California, alleging that they suffered substantial losses by trading in securities as a result of a manipulative scheme engaged in by petitioner's employee Charles Lazzaro and Leslie Neadeau, president of T.O.N.M. Oil & Gas Exploration Corporation (TONM) (J.A. 5-27).[1] Respondents allege, inter alia, that this scheme violated Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b-5 promulgated thereunder (17 C.F.R. 240.-10b-5). Respondents claim that petitioner is liable for Lazzaro's fraudulent conduct as a "controlling person" with respect to Lazzaro under Section 20(a) of the Act (15 U.S.C. 78t(a)). J.A. 7, 14-17.

As set forth in respondents' complaint,[2] Lazzaro and Neadeau conspired to manipulate the price of TONM

[1] Although Lazzaro, Neadeau, and TONM are also respondents in this Court (Sup. Ct. R. 19.6), we shall for convenience use "respondents" to refer to the plaintiffs, who are defending the court of appeals' judgment in this Court.

[2] Because the district court dismissed the action pursuant to Fed. R. Civ. P. 12(b)(6), we construe the complaint in respondents' favor and assume the truth of their allegations.

stock by disseminating to investors false information about the company on the pretext that it was accurate inside information (J.A. 7-17). Lazzaro induced respondents to purchase substantial quantities of TONM stock by falsely representing to them that he had learned from TONM's president or vice-president that TONM had acquired the rights to a large gold discovery in Surinam and that the company was arranging to mine the gold (J.A. 10-12). Lazzaro told respondents that the discovery and mining preparations were not publicly known and that the price of TONM's stock would rise dramatically upon publication of the information (J.A. 11). The price of TONM stock increased from approximately $3 to $7 per share as a result of Lazzaro's activities, and then fell to less that $1 per share as the scheme came to an end (J.A. 13-14). Respondents suffered trading losses when the shares of TONM stock that they had acquired on Lazzaro's advice declined in value (J.A. 14).

Respondents admitted in their complaint that they purchased TONM stock "on the premise" that they had become "privy to certain information not otherwise available to the general public" (J.A. 10). Certain respondents also contacted Neadeau directly to confirm Lazzaro's information (J.A. 12). Neadeau refused to confirm or deny the story, but he did state that Lazzaro was "very trustworthy and a good man" (*ibid.*).

2. The district court dismissed the complaint for failure to state a claim (Pet. App. C1-C4). The district court ruled that respondents' Section 10(b) and Rule 10b-5 action was barred because they were *in pari delicto* with the defendants (Pet. App. C2-C3). The court stated that "trading on insider information is itself a violation of rule 10b-5" and that respondents had admitted in their complaint "that they acted on insider information (albeit false information) and therefore were tippees" (*id.* at C2). The district court refused to assess the relative fault of the parties on the ground that "both plaintiffs and defendants violated the particular statutory provision under which recovery is sought" (*ibid.*).

3. The court of appeals reversed (Pet. App. A1-A11). That court assumed that respondents had violated Rule 10b-5 by trading on what they believed to be inside information (Pet. App. A11). However, relying (*id.* at A3-A6) on the common law and on *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968), the court of appeals concluded that the *in pari delicto* defense should be available in private securities actions only where "the investor is equally responsible [with the defendants] for his injury" (Pet. App. A11). In the court's view, respondents' complaint did not demonstrate their equal responsibility in this case because "the fraudulent scheme was originated by the broker and his coconspirators to manipulate the market price of T.O.N.M. stock for their financial benefit * * * [and] the investors acted in reliance on [their] representations without knowledge of the true facts" (*id.* at A6).

The court of appeals emphasized that its holding is consistent with "the overall aims of the securities law, and of Rule 10b-5," and, indeed, that application of the *in pari delicto* defense in these circumstances would be "totally incompatible" with those goals (Pet. App. A9). The court reasoned that "[t]o allow professionals in the securities industry and corporate officers to hide behind the *in pari delicto* defense gives them a license to defraud the investing public with little fear of prosecution," because "[s]o long as these persons disseminated false information on the pretext that it was 'inside' information, they would be shielded from liability in a private civil action" (*ibid.*). Because plaintiffs must prove scienter in Rule 10b-5 actions,[3] the court of appeals rejected the notion that its holding would give investors a "warranty of accuracy" with respect to purported inside tips. Such investors, in the court's view, subject themselves to potential civil and criminal liability. Moreover, they "stand[] to lose all of [their] investment. Only in the situation where the investor has been deliberately defrauded will he be able to maintain a private suit in an attempt to recoup his money." *Id.* at A10-A11 n.2.

[3] *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

SUMMARY OF ARGUMENT

The question in this case is whether an action brought by defrauded investors under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder against a securities professional whose manipulative scheme caused their losses should be barred on the ground that they were *in pari delicto* with the defendant. Under the common law, the *in pari delicto* defense is a flexible doctrine applicable only where it will serve the public interest. In the usual case, that interest is best served by applying the defense only when the fault of the parties is relatively equal. Moreover, in light of the federal regulatory context presented by the securities laws, this Court's decision in *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968), requires that the *in pari delicto* defense be available only to the extent that it furthers Congress's purpose in the securities laws to protect the investing public.

Consideration of the relative positions of the parties in this action demonstrates that the securities professional was significantly more culpable than the investors he duped. The brokerage firm employee, acting in concert with a corporate insider, originated the manipulative scheme and took advantage of his fiduciary position to defraud his clients. Moreover, this Court's decision in *Dirks* v. *SEC*, No. 82-276 (July 1, 1983), establishes that purported tippees such as the investors here are less culpable than their tippers, because their breach of duty is only derivative of that of the tippers. For these reasons, the *in pari delicto* defense does not bar this suit by investors against the professional who defrauded them.

This result serves to further Congress's goals expressed in the federal securities laws. Private actions such as this one are an important complement to the Commission's own enforcement efforts. Application of the *in*

pari delicto defense in these circumstances would only encourage securities professionals to violate the law by misrepresenting to their clients that they possess material inside information or have inside sources to confirm market rumors. Private actions by defrauded investors will also best deter illegal tippee trading by cutting off the information at its source. This will not encourage investors themselves to engage in illegal trading because they typically trade on tips received only from trusted sources and so do not anticipate recovery in court if the tip turns out to be false. Moreover, the necessity of proving scienter in Rule 10b-5 actions dispels the notion that investors have a "warranty" of the accuracy of a tip. Finally, the substantial sanctions against illegal insider trading ensure that tippees cannot assume that they may trade with impunity.

ARGUMENT

AN EMPLOYEE OF A BROKERAGE FIRM WHO INDUCES INVESTORS TO PURCHASE SECURITIES BY DELIBERATELY MISREPRESENTING THAT HE HAS OBTAINED MATERIAL NONPUBLIC INFORMATION ABOUT THE ISSUER SHOULD NOT BE PERMITTED TO SHIELD HIMSELF FROM DAMAGES LIABILITY UNDER RULE 10b-5 ON THE GROUND THAT THE DEFRAUDED INVESTORS ARE *IN PARI DELICTO* WITH HIM BECAUSE THEY PURCHASED SECURITIES ON THE FALSE PREMISE THAT THEY WERE TIPPEES

This case requires a determination of the circumstances under which a private Rule 10b-5 action against a securities professional should be dismissed under the *in pari delicto* doctrine because the plaintiff's own wrongdoing is relatively equal to the defendant's.[4] The Commission does

[4] See *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134, 140 (1968); L. Loss, *Fundamentals of Securities Regulation* 1197 (1983) (emphasis omitted) ("[w]hen the [*in pari delicto*] doctrine is considered, one must remember an elementary bit of

not argue that this defense should never apply in private Rule 10b-5 actions. Nor does petitioner argue that the defense should be available irrespective of whether the fault of the parties is relatively equal. Rather, the issue is how to apply the "relatively equal fault" standard, as between an employee of a brokerage firm and the investors he has duped, in order best to effectuate the purposes of the federal securities laws.[5]

The Commission believes that a securities professional should be permitted to invoke the common law *in pari delicto* defense only where the plaintiff's fault is, in fact, substantially equal to or greater than his own—for example, where the plaintiff was involved in an actual conspiracy with the professional to misuse inside information for their mutual benefit or where the plaintiff instigated the professional's violation of law. Because respondents' complaint does not establish such culpability on their part, the court of appeals correctly held that the complaint withstands dismissal on *in pari delicto*

Latin translation sometimes overlooked—that *pari delicto* means equal fault"). The most widely accepted description of the *in pari delicto* defense in cases arising under the federal securities laws requires that the fault of the parties be " 'mutual, simultaneous, and relatively equal.' " *Silverberg* v. *Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678, 691 (11th Cir. 1983), quoting *James* v. *DuBreuil*, 500 F.2d 155, 160 (5th Cir. 1974); *Mallis* v. *Bankers Trust Co.*, 615 F.2d 68, 76 n.6 (2d Cir. 1980), cert. denied, 449 U.S. 1123 (1981).

[5] Petitioner's argument that respondents are *in pari delicto* with its employee Lazzaro would free it of the possibility of derivative liability as a "controlling person" under Section 20(a) of the Act (see page 2, *supra*). Amicus Securities Industry Association (SIA) argues (Br. 20-24), on the other hand, that the *in pari delicto* defense bars the "secondary" liability of a brokerage firm for the fraud of its employee even if the employee himself cannot successfully invoke the defense. Because this issue was not decided by the court of appeals and has not been raised by petitioner either in this Court or in the court of appeals (see *id.* at 20 n.28), the Court need not now decide the question, and the Commission expresses no view on it.

grounds.[6] To allow the defense in the circumstances of this case would have a deleterious impact on compliance with and enforcement of the federal securities laws.

A. The Common Law *In Pari Delicto* Defense Should Be Applied Only Where The Plaintiff's Fault Is, Under All The Circumstances, Relatively Equal To The Defendant's And Application Of The Defense Advances The Objectives Of The Securities Laws

Congress has left to the courts the determination of the role of the *in pari delicto* doctrine in private securities actions under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. See generally *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 389 (1983); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 749 (1975); see also *A.C. Frost & Co.* v. *Coeur D'Alene Mines Corp.*, 312 U.S. 38, 42-45 (1941). At common law, courts have generally rejected the notion, relied on by the district court (Pet. App. C2), that the parties' fault is substantially equal merely because they have engaged in the same type of wrongdoing. Courts have eschewed rigid application of the *in pari delicto* doctrine in favor of a flexible approach that better serves the

[6] The court of appeals did not hold, and we of course do not argue, that a defrauded investor is entitled to recover in these circumstances the profits he would have obtained had the purported inside information been true. See generally *McMullen* v. *Hoffman*, 174 U.S. 639 (1899) (co-conspirators cannot recover profits resulting from their wrongdoing). Rather, the usual "out-of-pocket losses" or rescissory measure of damages should be applied. See, *e.g.*, *Hatrock* v. *Edward D. Jones & Co.*, No. 83-4182 (9th Cir. Dec. 28, 1984), slip op. 5594 n.4. As we demonstrate below (pages 21-30), such relief is fully consistent with public policy. Because it allows the plaintiff to recover only his losses and not his profits, this result does not violate "[t]he principle that a wrongdoer shall not be permitted to profit through his own wrongdoing * * *, [on which] [t]he traditional doctrine of *in pari delicto* is itself firmly based" (*Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134, 151 (1968) (Marshall, J., concurring in the result)).

public interests at stake in each particular case. Courts have reasoned that public policy argues for barring suit only when the fault of the plaintiff is, under all the circumstances, relatively equal to that of the defendant. This Court has likewise relied on public policy considerations in recognizing the limited relevance of the *in pari delicto* defense to private actions brought to enforce rights under a federal regulatory scheme, particularly where the fault of the parties is not relatively equal. *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968).

Based upon these principles, the Commission believes that, in private securities actions, a duped investor who trades on what he mistakenly believes to be inside information should not be barred on *in pari delicto* grounds merely because he violates the same statute as the securities professional who defrauded him. This determination is guided by Congress's purposes in enacting the federal securities laws.

1. The *in pari delicto* defense is a common law doctrine denying a plaintiff the right to sue because of the plaintiff's own misconduct where his fault is relatively equal to the defendant's. To ensure that the doctrine properly effectuates public policy, common law courts frequently refused to allow the defense where the culpability of the defendant was substantially greater than that of the plaintiff, judged by the public interests at stake.[7] While the doctrine "'is based on the principle that to give [a wrongdoer] relief * * * would contravene public morals and impair the good of society,'" the public policy principles that support the doctrine also limit its application: the defense must "'not be applied in a case in which to withhold relief would, to a greater extent, offend public morals. To promote the good of the public is the highest aim of the courts in application of this doctrine.'" *Falkenberg* v. *Allen*, 18 Okla. 210, 217, 90 P.

[7] See generally Wade, *Restitution of Benefits Acquired Through Illegal Transactions*, 95 U. Pa. L. Rev. 261 (1947).

415, 418 (1907), quoting *Hobbs* v. *Boatright*, 195 Mo. 693, 715, 93 S.W. 934, 935 (1906). By allowing the less culpable party to recover against the more culpable, the common law courts deterred the primary wrongdoer, who was often the instigator of the illegal conduct, by placing the risk of loss on him.

Because the *in pari delicto* doctrine rests "on public policy considerations," the comparison of the relative fault of the parties is not based on "a neat calculus." *Golberg* v. *Sanglier*, 96 Wash. 2d 874, 883, 639 P.2d 1347, 1353 (1982).[8] Although it is difficult to generalize beyond the overriding public policy requirement concerning the circumstances in which courts will view the parties' fault as relatively equal,[9] certain related principles do follow.

Courts have generally looked to the surrounding circumstances, as well as to the nature of the parties' wrongdoing, in evaluating their relative fault. For example, the plaintiff's fault is not considered equal to the defendant's where the plaintiff "was induced through the fraudulent representations" to engage in an unlawful transaction. 3 J. Pomeroy, *A Treatise on Equity Jurisprudence* § 942a, at 741 (5th ed. 1941); see *National Bank & Loan Co.* v. *Petrie*, 189 U.S. 423, 425 (1903) (the "usual consequence [of fraud] is that as between the parties the one who is defrauded has a right, if possible, to be restored to his former position").[10] Thus, in *Stewart* v. *Wright*, 147 F. 321

[8] See also, *e.g.*, *Stewart* v. *Wright*, 147 F. 321, 329 (8th Cir.), cert. denied, 203 U.S. 590 (1906); *Gilchrist* v. *Hatch*, 183 Ind. 371, 375-377, 106 N.E. 694, 696 (1914); *Hobbs* v. *Boatright*, 195 Mo. at 715, 93 S.W. at 935; *Gorringe* v. *Reed*, 23 Utah 120, 130, 63 P. 902, 904 (1901).

[9] See Wade, *supra*, 95 U. Pa. L. Rev. at 280 ("the conveniently vague doctrine that there may be relief when the parties are not *in pari delicto* provides an acceptable technique for reaching the desired result").

[10] See also, *e.g.*, *National City Bank* v. *Carter*, 31 F.2d 25, 27 (6th Cir.), cert. denied, 280 U.S. 559 (1929); *In re E.J. Arnold & Co.*, 133 F. 789, 792, 793 (E.D. Mo. 1904); *Golberg* v. *Sanglier*, 96

(8th Cir.), cert. denied, 203 U.S. 590 (1906), the court viewed as "altogether too superficial" (147 F. at 332) the contention that the plaintiff was *in pari delicto* with the persons who defrauded him, where the defendants "awakened in [the plaintiff] a desire for wrongful gain that might otherwise have remained dormant, inspired in his mind an unfounded idea that he was going to secure it, and then by fraud and false pretenses deprived him of his money" (*id.* at 328-329). Similarly, in *Sparkman* v. *Triplett*, 292 Ky. 569, 574, 167 S.W.2d 323, 326 (1943), the court concluded that the *in pari delicto* defense should not be extended "to a case in which the defending party had himself first conceived the fraud for his own benefit." Courts have also frequently considered important "the existence of a confidential relationship between the [parties] * * * in determining their relative standing." 3 J. Pomeroy, *supra*, § 942a, at 741.[11] Finally, as petitioner recognizes (Br. 21-22), the defense is applied in those circumstances where it will serve to deter wrongdoing.[12]

Wash. 2d at 886-888, 639 P.2d at 1355; *Grim* v. *Cheatwood*, 208 Okla. 570, 571, 257 P.2d 1049, 1051 (1953); *Thompson* v. *Lyons*, 281 Mo. 430, 453, 220 S.W. 942, 947 (1920); *Brady* v. *Central W.R.R.*, 88 Neb. 840, 842, 130 N.W. 575, 576 (1911); *Falkenberg* v. *Allen*, 18 Okla. 210, 215-219, 90 P. 415, 417-418 (1908); *Lockman* v. *Cobb*, 77 Ark. 279, 288-289, 91 S.W. 546, 550 (1905); *Hess* v. *Culver*, 77 Mich. 598, 601, 43 N.W. 994, 994-995 (1889); *Webb* v. *Fulchire*, 25 N.C. 485, 487 (1843).

[11] See, *e.g.*, *Staufenbiel* v. *Staufenbiel*, 388 Ill. 511, 522-523, 58 N.E.2d 569, 573 (1945); *Harrety* v. *Kontos*, 238 Mo. App. 519, 184 S.W.2d 195 (1944); *Rozell* v. *Vansyckle*, 11 Wash. 79, 85-86, 39 P. 270, 272 (1895); *Barnes* v. *Brown*, 32 Mich. 146, 153 (1875); see also Wade, *supra*, 95 U. Pa. L. Rev. at 276.

[12] The courts therefore consider not merely whether permitting the defense will deter the plaintiff's misconduct but also whether it will unduly encourage wrongful conduct by the defendant (*Stewart* v. *Wright*, 147 F. at 329):

> It would be doubtful wisdom to extend encouragement to organizations of confidence men, who prey upon the public, by allowing them the use of the rule "in pari delicto" as a

These principles preclude the district court's interpretation (Pet. App. C2) that the parties' fault is relatively equal merely because they have violated the same statute,[13] as well as petitioner's related suggestion (Br. 19-20) that a party who has engaged in fraud is in all circumstances barred from recovery for his losses. Petitioner's reliance on *McMullen* v. *Hoffman*, 174 U.S. 639 (1899), and *Meguire* v. *Corwine*, 101 U.S. 108 (1880), is misplaced. In both cases, the Court simply refused to enforce illegal contracts between the parties, where the plaintiffs demanded sums due them under those contracts. Here, by contrast, respondents may recover only the out-of-pocket losses sustained as a result of the defendants' fraud; they may not recover their expected profits (see note 6, *supra*).

2. This Court's decision in *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968), underscores the significance of public-policy concerns for application of the *in pari delicto* doctrine. In *Perma Life*, the Court stressed (*id.* at 138) "the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes" and, accordingly, held (*id.* at 140) that "the doctrine of *in pari delicto*, with its complex scope, contents, and effects is not to be recognized as a defense to an antitrust action."[14] The Court's opinion in *Perma Life* (392 U.S. at 138-140), as well as the separate concurrences of Justices White (*id.* at 143, 146), Fortas (*id.* at 147), and Marshall (*id.* at 148-149), demonstrate the relevance of the federal regulatory scheme under which the plaintiff seeks recovery to a delineation of the role of the *in pari delicto* doctrine.

Justice White, who joined the Court's opinion, wrote separately to express his view (392 U.S. at 143) that the basis for "sorting out those situations in which the plaintiff might be barred because of his own conduct from those in which he may have been a party to an illegal venture but is still entitled to damages from other participants" must lie in "the aims and purposes" of the federal antitrust laws. Justice White concluded (*id.* at 146) that recovery should be denied "where plaintiff and defendant bear substantially equal responsibility for injury resulting to one of them," but permitted where "one is more responsible than the other." Four other Justices would have applied the *in pari delicto* doctrine to antitrust actions, although they stressed the importance of the plaintiff's equal fault as a condition for application of the defense. See *id.* at 147 (Fortas, J., concurring in the result); *id.* at 149 (Marshall, J., concurring in the result); *id.* at 153-155 (Harlan, J., joined by Stewart, J., concurring in part and dissenting in part).

---

shield of defense, when a part of the scheme they employ is to place those they seek and then defraud in the position [of wrongdoers] they rely on [for their defense].

[13] While many courts have stated that a plaintiff who violates the same law as a defendant is *in pari delicto* with him, the modern approach is to apply the doctrine in a more flexible manner. See, *e.g.*, *Golberg* v. *Sanglier*, 96 Wash. 2d at 888, 639 P.2d at 1356 (" '[t]he trend of modern jurisprudence is to get away from the technical' " application of the doctrine), quoting *Wright* v. *Stewart*, 130 F. 905, 921 (D. Mo. 1904), aff'd, 147 F. 321 (8th Cir.), cert. denied, 203 U.S. 590 (1906); *National City Bank* v. *Carter*, 31 F.2d at 27; *Tri Q, Inc.* v. *Sta-Hi Corp.*, 63 Cal. 2d 199, 218-219, 404 P.2d 486, 497-498, 45 Cal. Rptr. 878, 889-890 (1965); see generally J. Story, *Commentaries on Equity Jurisprudence* 304-305 (1886); cf. Restatement (Second) of Torts § 889 & comment c (1977). Congress presumably intended that the flexible approach described more fully in the text apply to securities actions, because it better serves the purposes of the securites laws. See *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) ("Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels."); see also *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 388-389 & nn.27, 28 (1983).

[14] See *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556, 569 (1982) ("In *Perma Life Mufflers*, the Court honored [the purposes of the antitrust laws] by denying defendants the right to invoke a common-law defense (the doctrine of *in pari delicto*) that was inconsistent with the antitrust laws.").

3. Advancement of the purposes of the federal securities laws must, in light of both the common law and *Perma Life*, be the touchstone for application of the defense in this case. As the court stated with respect to Rule 10b-5 actions in *Tarasi* v. *Pittsburgh National Bank*, 555 F.2d 1152, 1162 (3d Cir.), cert. denied, 434 U.S. 965 (1977):

> *Perma Life* teaches that *in pari delicto* should not be applied mechanically when the public interest is present. Rather, it is necessary to assess the impact upon the enforcement of a regulatory system before sanctioning its application.

See also *Kuehnert* v. *Texstar Corp.*, 412 F.2d 700, 704 (5th Cir. 1969) ("The question must be one of policy: which decision will have the better consequences in promoting the objective of the securities laws by increasing the protection to be afforded the investing public."); *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. 451, 453 (D.D.C. 1979) ("[I]t must be determined that the regulatory purpose of the securities laws, protection of the investing public, is best served by allowing rather than disallowing the defense."); *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50, 52-53 (S.D.N.Y. 1971) (the "basic question" is "what policy with respect to the allowance or disallowance of the defense would best serve to carry out the prime purpose of the securities laws to protect the investing public") (footnote omitted). As at common law, the purposes of the federal securities laws are best achieved by allowing the *in pari delicto* defense only where the fault of the plaintiff, under all the circumstances, is relatively equal to that of the defendant.

Contrary to petitioner's contention (Br. 31-35), the fact that the private right of action for violation of Section 10(b) and Rule 10b-5 is implied rather than express does not make either *Perma Life* or Congress's purposes in enacting the securities laws irrelevant. Nothing in *Perma Life* suggests that the Court's public

policy analysis is limited to express statutory remedies. Moreover, the *in pari delicto* doctrine itself requires an analysis of the public policy implications of applying the defense (see pages 9-10, *supra*).[15] Finally, petitioner fails to acknowledge the importance of implied private actions to enforcement of the securities laws. This Court has consistently noted the significance of "private enforcement [as] * * * 'a necessary supplement to Commission action.'" *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. at 730, quoting *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964). Indeed, in *J.I. Case* (377 U.S. at 432), the Court placed private securities actions on a par with private antitrust actions insofar as they contribute to assuring compliance with the underlying statute. And the Court has not hesitated, where necessary, to depart from technical common law limitations in construing the securities laws. See *Herman & MacLean* v. *Huddleston*, *supra* (common law standard of clear and convincing evidence does not apply to private actions under Section 10(b)); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) ("Congress intended * * * securities legislation 'enacted for the purpose of avoiding frauds'" to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes") (footnote omitted). So here. Our submission does not repudiate the common law, but—consistently with both the common law and *Perma Life*—we urge that furtherance of public policy, here embodied in the Securities Exchange Act, be the goal in application of

---

[15] Petitioner's invocation (Br. 35) of the common-law savings clauses in the securities statutes is therefore irrelevant. Petitioner admits (Br. 28 nn.21, 22) that the Court's analysis in *Perma Life* may be regarded as consistent with the common law *in pari delicto* doctrine. In our view, *Perma Life* serves, in a regulatory context such as the securities area, to focus the courts' attention on the purposes of the regulatory scheme in considering the role, if any, of the defense. This is completely consistent with the common law's emphasis on public policy considerations in applying the doctrine.

the *in pari delicto* doctrine, and that public policy is best furthered by applying the defense only where the fault of the parties is relatively equal.[16]

B. Because The Securities Professional In This Case Was Far More Culpable Than The Victims Of His Manipulative Scheme, He Cannot Avoid Liability Under The *In Pari Delicto* Doctrine

1. Before addressing the question whether the fault of respondents was relatively equal to that of petitioner's employee, it is necessary to consider whether respondents were at fault at all. In *Dirks* v. *SEC*, No. 82-276 (July 1, 1983), the Court held that a tippee does not violate Rule 10b-5 when trading on inside information merely by "knowingly receiv[ing] nonpublic material information from an insider" (slip op. 9). Rather, a tippee inherits from his insider source a duty to disclose or to abstain from trading only when the insider himself has violated his fiduciary duty to shareholders by disseminating corporate information *and* where the tippee knows or should know of the insider's breach of duty (*Dirks*, slip op. 13). "All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders" (*id.* at 15), even when there is "reason to believe

---

[16] See page 14, *supra*; *Chemetron Corp.* v. *Business Funds, Inc.*, 682 F.2d 1149, 1182 (5th Cir. 1982), vacated and remanded on other grounds, 460 U.S. 1007 (1983), quoting *Woolf* v. *S.D. Cohn & Co.*, 515 F.2d 591, 604, on reh'g, 521 F.2d 225 (5th Cir. 1975), vacated and remanded on other grounds, 426 U.S. 944 (1976):

> "[E]ven in a case where the fault of plaintiff and defendant were relatively equal, simultaneous and mutual, the court might still reject the [*in pari delicto*] defense if it appeared that the defendant's unlawful activities were of a sort likely to have a substantial impact on the investing public, and the primary legal responsibility for and ability to control that impact is with defendant."

See also *Mallis* v. *Bankers Trust Co.*, 615 F.2d 68, 76 n.6 (2d Cir. 1980), cert. denied, 449 U.S. 1123 (1981).

that * * * outsider[s] may use it to the disadvantage of the shareholders" (*id.* at 19 n.27). The test is "whether the insider personally will benefit, directly or indirectly, from his disclosure" (*id.* at 15), by receiving, for example, "a pecuniary gain or a reputational benefit that will translate into future earnings" (*id.* at 17). The insider likewise could benefit by making "a gift of confidential information to a trading relative or friend" (*ibid.*).[17]

Judged by these standards, it is not clear on the face of respondents' complaint that they are guilty of an attempted violation of Rule 10b-5 under traditional notions of tippee liability for having traded on the mistaken assumption that Lazzaro was privy to information emanating from a corporate insider (see J.A. 11).[18] In evaluating respondents' conduct under an attempt theory, the Court must "assume the facts as the [respondents] thought them to be when engaging in their allegedly wrongful conduct." *Schick* v. *Steiger*, 583 F. Supp. 841, 847 (E.D.

---

[17] The insider's breach and the tippee's knowledge can of course be established by circumstantial evidence (see *Dirks*, slip op. 16).

[18] There is no basis for concluding that respondents actually violated Rule 10b-5. Petitioner argues repeatedly (Br. 3, 8, 12, 13, 15, 16, 43) that respondents traded not just on fabricated information but also on "actual" inside information. But the complaint, construed in a light most favorable to respondents, alleges that all of the potentially material information on which respondents traded was fabricated. In the court of appeals, moreover, petitioner argued that "the undisputed allegations of the Complaint demonstrate that no true inside information was disseminated by Lazzaro" (Appellees' C.A. Br. 17 n.12). The courts likewise analyzed the *in pari delicto* defense here on the premise that respondents traded on "false information" (Pet. App. C2) that was provided to them "on the pretext that it was inside information" (*id.* at A2). In our view, whether the information was or was not false is not directly relevant to whether respondents had reason to believe that Neadeau, the insider, had violated a fiduciary duty by transmitting the information to Lazzaro. Moreover, it is not clear that false information could be "material" for purposes of an actual insider trading violation.

Mich. 1984).[19] Obviously, respondents were unaware that Neadeau stood to profit from stock manipulation, for they believed his information to be true. Further, respondents had no reason to suspect that Neadeau's purpose in disclosing the information to Lazzaro was to drive upward the price of TONM stock. If that had been his purpose, he presumably would have issued a press release announcing the company's good fortune. Although respondents might have believed that Neadeau had provided the information as a gift to Lazzaro or otherwise had violated his fiduciary obligations to the shareholders, respondents' complaint does not admit facts conclusively showing this to be the case. Because all doubts must be resolved in respondents' favor on the motion to dismiss, it may well be that respondents should not at this stage be considered guilty of an attempted violation of Rule 10b-5. See *Wager* v. *Pro*, 575 F.2d 882, 884-885 (D.C. Cir. 1976).[20]

---

[19] See also Wechsler, Jones, & Korn, *The Treatment of Inchoate Crimes in the Model Penal Code of the American Law Institute: Attempt, Solicitation, and Conspiracy*, 61 Colum. L. Rev. 571 (1961); Model Penal Code § 5.01(1)(a) (Proposed Official Draft 1962) ("A person is guilty of an attempt to commit a crime if, acting with the kind of culpability otherwise required for commission of the crime, he * * * purposely engages in conduct which would constitute the crime if the attendant circumstances were as he believes them to be.").

[20] Petitioner's argument (Br. 15) that respondents knew that Neadeau violated a duty by revealing purported inside information to Lazzaro rests entirely on the premise that any revelation of inside information violates the insider's duty, a premise the Court expressly rejected in *Dirks*. The Court noted in *Dirks* that an insider may "act consistently with his fiduciary duty to shareholders" by "disclos[ing] information to analysts" even where "release of the information may affect the market" (slip op. 15)—indeed, that was precisely the situation in *Dirks* itself. Petitioner's reliance (Br. 16, 46) on cases decided before *Dirks* is misplaced. In *Tarasi* v. *Pittsburgh National Bank*, 555 F.2d 1152, 1161 (3d Cir.), cert. denied, 434 U.S. 965 (1977), for example, the court erroneously assumed that a tippee violates Rule 10b-5 merely by

2. a. Even if respondents did violate or attempt to violate Rule 10b-5, their conduct was far less culpable than that of Lazzaro when measured by traditional common law precepts developed under the *in pari delicto* doctrine. Lazzaro originated the scheme to manipulate the market in TONM securities without respondents' participation or knowledge. While respondents were not coerced into trading on TONM stock, they were duped by Lazzaro solely for his own benefit (along with that of his coconspirator Neadeau). At common law, Lazzaro would not be able to take advantage of the *in pari delicto* defense because of his greater fault in conceiving the fraudulent scheme for his own benefit, as compared to the fault of the victims he lured into trading on what they believed to be inside information (see pages 10-11, *supra*).

Of equal significance under the common law, Lazzaro took advantage of his fiduciary relationship as a securities professional[21] to defraud his clients. Fraud by such

---

trading while in possession of undisclosed inside information. Petitioner's attempt (Br. 17 n.12) to distinguish recent cases holding that the *in pari delicto* defense is inapplicable where a purported tippee is defrauded by a person who is not an insider or acting in concert with one is unpersuasive, for petitioner has not shown how respondents' complaint admits facts putting them on notice of the insider's breach. See *Silverberg* v. *Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678, 691 (11th Cir. 1983); *Wise* v. *Kidder Peabody & Co.*, 596 F. Supp. 1391, 1395 (D. Del. 1984); *Schick* v. *Steiger*, 583 F. Supp. 841, 846-848 (E.D. Mich. 1984); *Wilkinson* v. *Paine, Webber, Jackson & Curtis, Inc.*, 585 F. Supp. 23, 25 (N.D. Ga. 1983); *Xaphes* v. *Shearson, Hayden, Stone, Inc.*, 508 F. Supp. 882, 885-887 (S.D. Fla. 1981). But see *Summerlin* v. *Blyth Eastman Dillon & Co.*, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197 (N.D. Ga. Mar. 23, 1983). It would make little sense to adopt petitioner's approach, which would allow brokers to avoid liability if they artfully suggest an insider source for their information.

[21] See *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (6th Cir. 1979); *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); S. Jaffe, *Broker-Dealers and Securities Markets* § 7.09 (1977); N. Wolfson, R.

a fiduciary who owes special duties to his clients is more blameworthy and more serious in its implications than is fraud by an ordinary investor.[22] A securities salesperson is responsible for ensuring that he does not induce unlawful trading by his customers. He is in a far better position than his customers to determine whether information he provides to them is legally available for use under *Dirks*—a "question of fact" that is "not always * * * easy [even] for courts" to decide (*Dirks*, slip op. 17). A customer might trade on nonpublic information provided to him by his broker without knowing that his use of the information is unlawful under *Dirks*.[23] While the customer's ignorance of the law would be no defense in an action against him by the Commission, it is a relevant factor in assessing the relative culpability of the customer and his broker.

b. Both this Court and Congress have also made clear that tippees are less culpable than their tipper sources. As noted above (pages 16-17), the Court held in *Dirks* that a tippee's duty is "derivative from * * * the insider's duty" (slip op. 12). Thus, even if respondents did at-

---

Phillips & T. Russo, *Regulation of Brokers, Dealers and Securities Markets* ¶ 2.03 (1977 & Supp. 1984); 5B A. Jacobs, *Litigation and Practice Under Rule 10-5* § 210.03 (2d rev. ed. 1984).

[22] Petitioner's (Br. 43-46) and amicus Securities Industry Association's (SIA's) (Br. 8-19) arguments to the contrary lack merit. That Rule 10b-5 applies to "any person" does not mean that an investor who violates the Rule is necessarily as blameworthy as a securities professional who violates it. The application of Rule 10b-5 to "any person" is intended to ensure that it sweeps broadly to capture all potential violators; the language certainly was not intended to eliminate distinctions between the relative culpability of differently situated violators. A securities professional does bear a special fiduciary relationship to his customers. His customers do not owe such a reciprocal duty to him. This relationship between the parties is significant for assessment of the parties' relative fault under the *in pari delicto* doctrine (see page 11, *supra*).

[23] See Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 Vand. L. Rev. 1273, 1279 n.26 (1984).

tempt to violate Section 10(b) and Rule 10b-5, their role as "'participant[s] after the fact in the insider's breach of a fiduciary duty'" (*Dirks*, slip op. 12, quoting *Chiarella* v. *United States*, 445 U.S. 222, 230 n.12 (1980)) cannot make their culpability equal to that of Lazzaro, who, acting in concert with Neadeau, violated a direct duty owed to TONM's shareholders.

Similarly, Congress, in enacting the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 *et seq.*, imposed a civil penalty on nontrading tippers (§ 2, 98 Stat. 1264) on the premise that tippers are the parties most responsible for any fraud on the investing public:

> "Tippers" often obtain material nonpublic information as a result of a position of trust and confidence. Absent the tipper's misconduct, the tippee's trading would not occur. Thus, the new civil penalty would be imposed upon *those persons most directly culpable in a violation.*

H.R. Rep. 98-355, 98th Cong., 1st Sess. 9 (1983) (emphasis supplied).

C. Allowing Duped Investors To Recover Their Trading Losses From The Securities Professional Who Defrauded Them Promotes The Purposes Of the Federal Securities Laws

Aside from the substantially greater fault of the securities professional in this case, the *in pari delicto* doctrine should not be applied here because allowing actions by duped investors such as respondents to go forward will further the public interest as expressed by Congress in the federal securities statutes. The cases relied on by petitioner (Br. 25 & n.17) uphold the defense against purported tippees in the belief that such a course will best deter illegal tippee trading.[24] But we submit that

---

[24] See *Wolfson* v. *Baker*, 623 F.2d 1074, 1082 (5th Cir. 1980), cert. denied, 450 U.S. 966 (1981); *Tarasi* v. *Pittsburgh National Bank*, 555 F.2d at 1159, 1162-1164; *Malamphy* v. *Real-Tex Enterprises, Inc.*, 527 F.2d 978, 980 (4th Cir. 1975) (relying on Fifth

the sounder view is that of the courts that have found the defense unavailable on the reasoning that this result will best deter insiders and brokers from tipping both false and true information.[25]

The Commission believes that the court of appeals in this case was correct in concluding (Pet. App. A9) that barring respondents' Rule 10b-5 action on *in pari delicto* grounds would be "totally incompatible with the overall aims of the securities laws, and of Rule 10b-5."[26] Private actions such as this one are essential to effectuate Congress's intent to hold securities professionals to high ethical standards and to discourage fraudulent and manipulative activities on the part of those professionals. Further, allowing these suits to go forward will not undermine deterrence of illegal tippee trading, but rather will further the goal of preventing such activity.

Circuit precedent); *James* v. *DuBreuil*, 500 F.2d 155, 160 (5th Cir. 1974); *Kuehnert* v. *Texstar Corp.*, 412 F.2d at 704-705; *Grumet* v. *Shearson/American Express, Inc.*, 564 F. Supp. 336, 341 (D.N.J. 1983); *Kirkland* v. *E.F. Hutton & Co.*, 564 F. Supp. 427, 435-437 (E.D. Mich. 1983); *In re Haven Industries, Inc.*, 462 F. Supp. 172, 180 (S.D.N.Y. 1978); *Summerlin* v. *Blyth Eastman Dillon & Co.*, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,197, at 95,793.

[25] See Pet. App. A6-A10; *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. at 453; *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. at 53-58; see also *Kuehnert* v. *Texstar Corp.*, 412 F.2d at 705-707 (Godbold, J., dissenting).

[26] The Commission's prediction concerning the likely enforcement consequences of not applying the *in pari delicto* defense in suits by defrauded tippees is entitled to deference: " 'a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency.' " *FCC* v. *National Citizens Committee for Broadcasting*, 436 U.S. 775, 814 (1978), quoting *FPC* v. *Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 29 (1961). See generally *SEC* v. *New England Electric System*, 390 U.S. 207, 211 (1968); *United States* v. *Shimer*, 367 U.S. 374, 382 (1961); *SEC* v. *Chenery Corp.*, 332 U.S. 194 (1947); *American Power & Light Co.* v. *SEC*, 329 U.S. 90, 112 (1946). While cases raising the question of deference to agency expertise normally arise in the context of review of administrative

1. *Denial Of The* In Pari Delicto *Defense In This Case Promotes Congress's Purpose To Impose High Ethical Standards On Securities Professionals And To Deter Them From Engaging In Fraudulent And Manipulative Schemes*

In enacting the federal securities laws, Congress intended to protect investors and the economy as a whole by imposing " 'a high standard of business ethics * * * *in every facet of the securities industry.*' " *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979), quoting *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 186-187 (emphasis in original); see also *Herman & MacLean* v. *Huddleston*, 459 U.S. at 389 ("an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry"). Congress was particularly concerned in the Securities Exchange Act with the ability of brokers and dealers to manipulate securities markets through circulation of false information.[27] Congress therefore prohibited brokers and dealers from engaging in such practices with securities traded on national exchanges, and it made them liable in damages to investors injured by such prac-

---

orders or rules, the same principle should apply here, where the direction in which the public interest lies is peculiarly within the Commission's specialized purview.

[27] The Senate hearings and report on stock exchange practices that formed the basis for the Act documented the practices of brokers manipulating the price of securities for their own benefit, as alleged in this case, by disseminating misleading information concerning those securities to their customers. S. Rep. 1455, 73d Cong., 2d Sess. 41-45 (1934). Such practices, the Senate concluded (*id.* at 43), "[could] not be condemned more severely." See *Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 5895-5904 (1934); see also *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976) (noting that a principle objective of the Securities Exchange Act was "to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets").

tices. See Section 9(a)(3)-(5) and (e) of the Act, 15 U.S.C. 78i(a)(3)-(5) and (e). And securities professionals are of course subject to the antifraud provisions of Section 10(b) of the Act and Rule 10b-5.

a. The private Rule 10b-5 action importantly contributes to achieving Congress's goal by deterring fraudulent practices by professionals in the brokerage industry—the professionals who play the most critical role in maintaining the integrity of the securities markets.[28] Rule 10b-5 actions are particularly significant in deterring brokerage professionals from misrepresenting to customers that they have "sources" to verify market rumors and from otherwise fabricating "tips" of supposed nonpublic information. See, *e.g.*, *Hatrock* v. *Edward D. Jones & Co.*, No. 83-4182 (9th Cir. Dec. 28, 1984) (brokerage firm employee found to have feigned calling a nonexistent "source" in his customer's presence to induce stock purchase). Private actions are common under Rule 10b-5 against securities salesmen who allegedly have used false suggestions or direct misrepresentations that they have "inside" information to induce customers to purchase securities, thereby earning commissions for themselves. See, *e.g.*, *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. at 453 ("the Court takes judicial notice of a tendency on the part of brokers to suggest or intimate that they are in possession of information not generally available"); *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. at 51; *Kirkland* v. *E.F. Hutton & Co.*, 564 F. Supp. 427, 432 (E.D. Mich. 1983); *In re Haven Industries, Inc.*, 462 F. Supp. 172, 173-177 (S.D.N.Y. 1978). The court of appeals correctly recognized (Pet. App. A9) that indiscriminate use of the

[28] See *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. at 54; *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp. at 453; see also *Fratt* v. *Robinson*, 203 F.2d 627, 632 (9th Cir. 1953) ("[N]othing * * * would more certainly tend to deter fraudulent practices in security transactions * * * than the right of defrauded sellers or buyers of securities to seek redress in damages in federal courts."); see also page 20, *supra*.

in pari delicto defense would effectively shield such fraudulent practices from private suit. Under the per se approach advocated by petitioner, a brokerage firm salesman might protect himself from private actions by his customers by falsely representing that the source of his "tip" is an "insider" friend (*ibid.*).

Although brokerage firm salespersons are subject to criminal and civil governmental sanctions for engaging in such dishonest practices, these practices would, in the Commission's view, go largely undetected in the absence of private suits under Rule 10b-5. "[L]itigation among guilty parties serves to expose their unlawful conduct and render them more easily subject to appropriate civil, administrative, and criminal penalties." *Kuehnert* v. *Texstar Corp.*, 412 F.2d at 706 n.3 (Godbold, J., dissenting); see Comment, *Securities Regulation—In Pari Delicto as a Bar to Private Antifraud Action by Tippee against Tipper*, 43 Mo. L. Rev. 378, 386 (1978). Without the prospect of recovering his losses, an investor defrauded by a false tip has little incentive to expose the broker's wrongdoing because, by doing so, he exposes his own potentially illegal conduct.

Without the tippees' assistance, the Commission could not effectively prosecute false tipping—a difficult practice to detect. Indeed, amicus SIA argues (Br. 24) that fraudulent practices by securities salespersons are difficult to uncover even by their own brokerage firms. But, however that may be, the Commission does not have the resources to police the industry sufficiently to ensure that false tipping does not occur or is consistently discovered.[29] The court of appeals correctly concluded (Pet. App. A9) that allowing professionals to use the *in pari delicto*

[29] Phillips, *When a Broker Takes a Client for a Ride*, Bus. Wk. Feb. 25, 1985, at 87 (the Commission has stated that "the agency has the resources to handle only 'truly egregious cases.'").

defense "gives them a license to defraud the investing public with little fear of prosecution."

b. Congress's intent to subject securities brokers to liability in cases such as this is shown especially clearly in Section 9(e) of the Securities Exchange Act (15 U.S.C. 78i(e)). Section 9(e) overrides the common law rule denying coconspirators a right to contribution, which rests on the theory that "parties generally *in pari delicto* should be left where they stand." *Texas Industries, Inc.* v. *Radcliff Materials, Inc.*, 451 U.S. 630, 635 (1981); see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 647-648 (1972). This provision makes all willful participants in prohibited conduct subject to monetary liability, allowing a securities broker held liable under Section 9 to seek contribution from "any person who, if joined in the original suit, would have been liable to make the same payment." [30] As with Section 9(e), the court of appeals' decision in this case effectuates Congress's enforcement goal by ensuring that every participant in a manipulation is subject to monetary liability. Surely, the Congress that provided that a brokerage professional such as Lazzaro could recover from his fellow manipulators should be understood to have also permitted the victims of Lazzaro's manipulative scheme to sue him.[31]

---

[30] See also Section 18(b) of the Securities Exchange Act (15 U.S.C. 78r(b)); Section 11(f) of the Securities Act of 1933 (15 U.S.C. 77k(f)); 3 L. Loss, *Securities Regulation* 1739-1740 n.178 (2d ed. 1961).

[31] Petitioner argues (Br. 21) that "public confidence in the judicial process" will be undermined by allowing suits by persons such as respondents in this case. Allowing suits by persons who are less blameworthy than those they sue, suits that will advance the purposes of the securities laws, will in no way undermine public confidence in the integrity of the courts. Indeed, Congress obviously did not believe that allowing suit by a securities manipulator for contribution under Section 9(e) would undermine judicial integrity, even where the manipulator's fault is equal to that of the person he has sued.

2. *Denial Of The* In Pari Delicto *Defense In This Case Will Best Achieve Congress's Objective To Deter Illegal Tippee Trading*

There is no dispute that allowing suits such as this one to go forward will most directly deter fraudulent practices by securities salespersons.[32] The lower courts are divided, however, as to the likely effect on illegal tippee trading of allowing or not allowing the *in pari delicto* defense in circumstances such as these (see cases cited at notes 24-25, *supra*). Those courts that have applied the defense do recognize that "if a tippee has no remedy against an insider's private falsehoods, little deterrent against [the insider's misconduct] will exist" (*Kuehnert* v. *Texstar Corp.*, 412 F.2d at 705). But they reason that sacrificing the deterrent of private actions against insiders and securities professionals is necessary to discourage tippees from trading, on the theory that "[i]f a tippee can sue he has, in effect, an enforceable warranty that secret information is true" (*ibid.*). The Commission disagrees.

The Commission is of the view that illegal tippee trading is best deterred by cutting off true or purported inside information at the source—insiders and brokerage professionals. This goal is accomplished most directly by allowing suits such as this one to go forward. We believe that Judge Weinfeld reasoned correctly in *Nathanson* v. *Weis, Voisin, Cannon, Inc.* as follows (325 F. Supp. at 57-58, quoting *Kuehnert* v. *Texstar Corp.*, 412 F.2d at 706 (Godbold, J., dissenting)):

> The true insider or the broker-dealer is at the fountainhead of the confidential information * * *. If the prophylactic purpose of the law is to restrict the use of all material inside information until it is made available to the investing public, then the most effective means of carrying out this policy is to nip in the bud the source of the information, the tipper, by discouraging him from "making the initial dis-

---

[32] See, *e.g.*, *Tarasi* v. *Pittsburgh National Bank*, 555 F.2d at 1163 ("[t]he absence of this defense would have the greatest impact on deliberate purveyors of false information").

closure which is the first step in the chain of dissemination." This can most readily be achieved by making unavailable to him the defense of in pari delicto when sued by his tippee upon charges based upon alleged misinformation.

Corporate insiders and broker-dealers are not only the sources of inside information, they are also the persons most likely to respond to deterrence. They are more likely than ordinary investors to be advised by counsel and to be aware of the legal limitations on the use of nonpublic information in their possession. *Kuehnert*, 412 F.2d at 706 (Godbold, J., dissenting); *Nathanson*, 325 F. Supp. at 57-58. Private actions against them are therefore a most effective means of deterring their transgressions.

On the other hand, it is unrealistic to suppose that the bar to recovery erected by the *in pari delicto* defense has any substantial deterrent effect on the illegal use of inside information by tippees. Because investors typically receive nonpublic information from sources they trust, it is unlikely that tippees trade in anticipation of recovery against their sources if the information proves false.[33] And because investors are often unsophisticated and uncounselled, it is doubtful indeed whether, even if they considered possible recovery in a private action, the doctrine of *in pari delicto* would ever enter into their decisions.

Further, this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), has significantly undermined the notion that the tippee has an enforceable warranty of recovery if he is allowed to bring suit in cases such as this one, because a plaintiff in a Rule 10b-5

[33] See Comment, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses*, 58 Cal. L. Rev. 1149, 1159 & n.49 (1970) ("It is unlikely that the tippee would be deterred from using information gained from an insider by the knowledge that he could not recover from the insider. In most instances, tippees will have taken the tip from someone they trust, and therefore will not doubt the person's word. The tippee just wants to make money and does not think of possible adverse consequences."); Comment, *supra*, 43 Mo. L. Rev. at 384.

action must now prove that the defendant acted with scienter.[34] Thus, even if a tippee might consider, prior to trading, the prospects of recovering from his source should the information turn out to be false, he would have no assurance of recovery. As the court of appeals concluded, (Pet. App. A10-A11 n.2) "if the tip merely fails to 'pan out' or if the information itself proves accurate but the stock fails to move in the anticipated direction, the investor stands to lose all of his investment. Only in the situation where the investor has been deliberately defrauded will he be able to maintain a private suit in an attempt to recoup his money."

Nor can tippees assume that their potential liability is minimal. In recent years, numerous tippees have been the subject of well-publicized governmental and private actions.[35] The Insider Trading Sanctions Act of 1984 now imposes (§§ 2-3, 98 Stat. 1264-1265) substantial sanctions on persons who have used information illegally, including a civil penalty of three times the profits gained or losses avoided through illegal use of inside information, as well as criminal fines of up to $100,000. Like the plaintiffs in *Perma Life*, tippees are now "fully subject to civil and criminal penalties for their own illegal conduct" (392 U.S. at 139).

Finally, even if application of the *in pari delicto* doctrine did to some extent deter tippee trading, the Commission believes that this benefit is far outweighed by the accompanying loss in deterrence of fraudulent brokerage industry practices. Securities professionals are continually in a position to engage in fraudulent practices involving real and fictitious inside information. Tippees, on the other hand, are often nonprofessional investors who are rarely in a position to obtain or use inside information. "As between the broker-dealer * * * and the tippee, * * * the broker-dealer presents a

[34] This Court has noted the difficulty plaintiffs face in attempting to establish scienter. *Herman & MacLean* v. *Huddleston*, 459 U.S. at 390-391 n.30.

[35] See Langevoort, *supra*, 37 Vand. L. Rev. at 1275.

greater potential threat to undermining the statutory protection intended for the public investor." *Nathanson* v. *Weis, Voisin, Cannon, Inc.*, 325 F. Supp. at 57; see *Moholt* v. *Dean Witter Reynolds, Inc.*, 478 F. Supp at 453 ("[i]n the complex, highly regulated securities field, primary responsibility must rest on licensed brokers and their employees in order to achieve maximum conformance with federal statutes and implementing regulations"). We agree with the court of appeals (Pet. App. A9) that any benefit achieved "through imposition of the *in pari delicto* defense [in cases such as this one] is outweighed by the resulting adverse consequence to the market and innocent investors."

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

REX E. LEE
Solicitor General

LOUIS F. CLAIBORNE
Deputy Solicitor General

BRUCE N. KUHLIK
Assistant to the Solicitor General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

LARRY R. LAVOIE
Assistant General Counsel

COLLEEN P. MAHONEY
Special Counsel

DANIEL J. KRAUS
Attorney
Securities and Exchange Commission

MARCH 1985

☆ U. S. GOVERNMENT PRINTING OFFICE: 1985 461551 10197